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Supreme Court, U.S.
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No. 02-476

IN THE

Supreme Court of the United States

INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA, *et al.*,

Petitioners,

v.

REBECCA WATSON, ASSISTANT SECRETARY FOR LAND AND MINERALS MANAGEMENT, DOI, AND UNITED STATES DEPARTMENT OF THE INTERIOR,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

REPLY BRIEF

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STATEMENT PURSUANT TO RULE 29.6

Petitioner's corporate disclosure statement was set forth at page *ii* of the Petition for a Writ of Certiorari, and there are no amendments to that statement.

Petitioners, the Independent Petroleum Association of America and the American Petroleum Institute (collectively "the Associations"), submit this reply to address the now expanded view of the breadth of the discretion of the Secretary of the Interior ("Secretary") to establish royalty value reflected in the government's Brief of the Respondents in Opposition. ("U.S. Opp.") This more extreme reading of the Secretary's authority serves only to underscore the errors of the court of appeals and is fundamentally contrary to this Court's interpretation of the lease language in *Mobil Oil Exploration & Producing Southeast, Inc. v. United States*, 530 U.S. 604 (2000) ("*Mobil Oil*").

In the government's new view, when the governing statutes and leases prescribe that royalties are owed on the "value of production . . . from the leased area" (L-24), the quoted language means nothing itself, but only whatever the Secretary says it means in regulations. U.S. Opp. 14 (the "[quoted] terms . . . are not defined in the leases themselves . . . , [and] by leaving the crucial term 'value of production' undefined" the leases leave it to the Secretary to give it meaning through future regulations). In so arguing, the government abandons the well-established law that phrases such as "from the leased area" tether the Secretary's discretion to determine the value of production *at the lease* and not at some downstream location. *See* Pet. 5 n.1. This new view leads the government to leave unchallenged the Associations' showing (Pet. 11 & 20) that the downstream marketing costs at issue add value to the gas beyond its value at the lease.

In pressing for unbounded Secretarial discretion, the government ignores the Secretary's expressly stated basis for the regulations. Contrary to the government's suggestion that the regulations are a reasonable interpretation of the statutory "value of production" language, the Secretary's explicit basis for the regulations is that there is an implied covenant in its

lease contracts that lessees will bear all costs of marketing (wherever the sales occur) at their sole expense. (L-14.) To sustain its claim for *Chevron* deference, the government now distances itself from the Secretary's implied duty rationale. By insisting that the Secretary was interpreting an undefined statutory term rather than explicit or implicit contractual text, the government seeks deferential review. But the Secretary chose to interpret the term through a *covenant* purportedly inhering in all lease contracts. The Secretary's interpretation therefore cannot be entitled to *Chevron* deference, but rather should be judged under the neutral principles of contract interpretation. *See Mobil*, 530 U.S. at 607.

The court of appeals clearly erred in holding that deference was required because the lease contracts "lead us back to the agency . . . [for] they incorporate the regulations and recognize Interior's authority to modify them." Pet. App. 6a. To the contrary, *Mobil Oil* makes clear that this language of incorporation does not permit the Secretary to unilaterally change the contractual bargain under the leases. As this Court explained, the forms for Outer Continental Shelf lease contracts make the leases "subject to" certain future regulations, but not others. 530 U.S. at 615-16.

> This explicit reference to future regulations makes it clear that the catchall provision that references "all other applicable . . . regulations," . . . must include only statutes and regulations already existing at the time of the contract, . . . a conclusion not questioned here by the Government. . . . Without some such contractual provision limiting the Government's power to impose new and different requirements, the companies would have spent $156 million to buy next to nothing.

Id. at 616 (citation omitted). As the Associations showed in their Petition, the only future regulations incorporated into the contracts concern environmental and resource matters not

relevant to gas marketing or royalty value. Pet. 9 & 25-26. Similarly, the onshore lease form (L-37 § 2) does not explicitly make those contracts subject to future regulations on production removed and sold from the lease. The court of appeals read these lease provisions in a manner contrary to *Mobil Oil*.

Even if the Secretary's reliance on the purported implied covenant could be ignored, and the regulations were deemed founded on the Secretary's exercise of discretion to determine the value of production, the government's claim for *Chevron* deference would not sustain the regulations. The court of appeals' "back to the agency" approach simply begs the question: Is the Secretary's exercise of discretion within lawful bounds? It has been long-established and understood by the Secretary and the lessees that the Secretary's discretion to set the value of production is bounded by the obligation to base royalty on the value of production at the lease.[1] The Secretary certainly has discretion in the method used to determine the value at the lease, but the Secretary has no discretion to set royalty on the basis of value in excess of the value at the lease. *See* Pet. 23 n.16. By claiming royalty on marketing costs that add value after the production has left the lease, the Secretary plainly exceeded the governing statutes' bounds. Accordingly, the government's position cannot be sustained even under a *Chevron* analysis. *See* Pet. 27 n.19.

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1. The government asserts that "the regulations have never permitted lessees to deduct marketing costs simply because the gas is sold away from the lease[,]" U.S. Opp. 15-16, without addressing the Associations' showing (Pet. 6-7) of regulatory and judicial precedents supporting the deduction of downstream marketing costs. Similarly, the government invokes the lessees' express duty to place production in marketable condition at no cost to the lessor (U.S. Opp. 6) without acknowledging the Secretary's admission (L-14 and Pet. App. 32a) that "[w]e recognize that the obligation to place production in marketable condition is legally distinct from the issue of marketing the gas." Prior to 1997, the Secretary's regulations never explicitly denied the deduction of downstream marketing costs from a downstream sales price to derive the value of the gas at the lease.

In sum, the court of appeals and the government err in concluding that the lease contracts "lead back to the agency" and give the Secretary unfettered discretion to unilaterally impose new regulations that change the fundamental bargain underlying the lease contracts. The government has failed to square the ruling below with *Mobil Oil* and has not contested that the ruling creates an issue of overriding national importance affecting 60,000 oil and gas leases.

CONCLUSION

The petition for writ of certiorari should be granted.

Respectfully submitted,

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